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ABSTRACT

This report presents findings and recommendations resulting from a study on the costs and benefits of a Department of Education policy of encouraging lenders of student loans to grant forbearances to borrowers who experience temporary financial hardship but do not satisfy the specific conditions required for government-prescribed deferments. The government pays lenders a special allowance, based on the loan balance, to supplement the borrower's interest payment if interest rates rise. The study attempted to replicate with a larger sample an earlier study by the Office of the Inspector General which had concluded that forbearances should be curtailed. The current study, examined 24,493 student loan accounts and looked at both the public cost of forbearances that result in default but also the public savings from forbearances that prevented default and eventually led to continued repayment. It concluded that the use of forbearances saves the public far more than the cost of granting them. It found that the break even point was achieved when only 3 percent of the delinquent accounts were saved from default though actually 66 percent of accounts were saved from default by the forbearances. The report recommends that the Department of Education continue its policy of encouraging the broad use of forbearances on the basis that it is sound on both economic and humanitarian grounds. (DB)

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Executive Summary

Cost-Benefit Analysis of Forbearances

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Executive Summary

USA GROUP, Inc.
Cost-Benefit Analysis of Forbearances

Spring 1993

Introduction

USA GROUP, Inc. embarked in the fall of 1992 on an internal cost-benefit analysis of granting forbearances to student loan borrowers facing financial hardship. Prompting the study was a report released in the summer of 1992 by the U.S. Department of Education's Regional Inspector General for Audit (OIG). That study concluded that forbearances led to costly defaults in 75 of the 200 cases studied, and, therefore, the use of forbearances should be sharply restricted. USA GROUP sought to replicate that study on a larger sample, test its conclusions, and revisit the public policy implications of granting forbearances. The study focused on two specific research questions:

USA GROUP sought to replicate the OIG study on a larger sample, test its conclusions and revisit the public policy implications of granting forbearances.

- What was the distribution of outcomes of borrowers following the end of the initial forbearance period?

- What was the financial impact to the taxpayer of granting a forbearance to borrowers who had never made a payment before receiving a forbearance?

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Background

In September 1988, the U.S. Department of Education issued a bulletin (88-L-124, 88-G-148) encouraging lenders to grant forbearances. Forbearances temporarily delay or reduce loan repayment for borrowers who face financial hardship but do not satisfy specific conditions required for more formal, government-prescribed deferments. During the forbearance period, interest accrues on the loan and may be paid immediately by the borrower or is added to the balance the borrower must repay. According to the bulletin, "The appropriate use of . . . forbearance can be [an] effective tool for assisting borrowers in their repayment efforts, simplifying the lender's due diligence responsibilities, and reducing defaults."

The U.S. Department of Education encourages lenders to grant forbearances. ...

An OIG memorandum (Management Improvement Report No. 92-10) dated June 30, 1992, challenged the broad availability of forbearances and called for stricter standards, including prescribing time limits on the use of forbearances, prohibiting their use in conjunction with deferments, limiting a servicer's quota of forbearances, requiring that forbearances be justified in writing, and insisting that partial payment be required during forbearance periods.

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These recommendations grew out of an OIG study, focusing on student loan accounts for which a payment had never been made at the time a forbearance was granted. From a universe of 22,342 such accounts drawn from an unidentified loan servicer, the OIG analyzed 200 cases. On 115 of those loans, the borrower had not submitted a payment before, during, or after the forbearance period as of the date of the study, and 75 loans eventually defaulted. The OIG projected from its subset the government's costs associated with those forbearances to all Stafford loans serviced in a two-year time period ending June 30, 1989. The OIG conclusion: "The total cost to the Federal government for unnecessary forbearance . . . was approximately $7.6 million annually."

USA GROUP Methodology

The USA GROUP informal study, conducted in late 1992, focused on a comparable universe of 24,493 student loan accounts serviced by Education Loan Servicing Center, Inc. (ELSC), a USA GROUP affiliate. The analysis examined all of the accounts, which had been granted forbearances under two conditions:

- The borrower had not made a payment prior to the forbearance.
- The loan had exited forbearance between January 1, 1991, and April 30, 1992, and had been in repayment status for at least six months since that time.

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Specifically, the study checked on the performance of borrowers in repaying their loans after the forbearance period expired.

The USA GROUP inquiry added an analytical dimension that led to conclusions sharply contrasting with those of OIG. Not only did USA GROUP focus on the public *cost* of forbearances that result in default, but also on the public cost *savings* of forbearances that prevented default and instead led to continued repayment. A break-even analysis computed the number of loans that eventually defaulted versus those that did not. In addition, the analysis computed the government's subsidies on the defaulted loans and arrived at a break-even point (the percentage of loans that must be saved from default to compensate the government's cost on loans that default).

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USA GROUP acknowledges that for either the OIG or USA GROUP study to be truly scientific, a control group of borrowers who had been denied forbearance should have been isolated and followed over time to determine how many of those borrowers would actually default on their loans. Such a control group did not exist because denying a deserved forbearance contradicts federal policy and humanitarian concerns. This point is dealt with in the discussion section that follows.

Findings

- Of the 24,493 Stafford loans in the study, 8,363 (34%) ultimately defaulted, and 16,130 (66%) did not default (Table 1).
- Of the 16,130 (66%) that had not defaulted, 8,442 (35%) were current or paid-in-full; 4,467 (18%) were delinquent; and 3,221 (13%) were in deferment, a new forbearance, in grace, or interim (in-school) status (Table 2).
- The break-even analysis demonstrates that only 508 (3.15%) loans in the population of non-defaulted loans had to be saved from default to compensate for the government's cost on loans that defaulted. In reality, 16,130 (66%) of the loans were saved from default (Tables 3,4).

Discussion

The USA GROUP analysis of both costs and savings associated with defaults demonstrates that forbearances save the public far more than the cost of granting them. In fact, the analysis reveals that in the cases studied, the public broke even on the additional interest and special allowance costs associated with forbearances when only 3 percent of the delinquent accounts were saved from default. In the USA GROUP study, forbearances saved about 66 percent of affected accounts from default — a full 63 percent higher than the break-even point. Even in the highly unlikely event that all of the 4,467 borrowers the USA GROUP study identified as

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delinquent six months after their forbearance period ended ultimately defaulted on their loans, the break-even point would have been only 8.7 percent. This worst-case analysis would still place the portfolio in the USA GROUP study more than 57 percent above the break-even point.

These results mean that the cost of granting forbearances to borrowers who eventually default is recovered many times over by borrowers who do not default. Even in the absence of a control group, the result is dramatic enough to underscore the relative merit of forbearances.

USA GROUP's study results, bolstered by its real-life experience, cast a dramatically different light from the OIG study on the public policy issue raised by forbearances. The OIG recommendation to curtail forbearances was based purely on a cost argument. The USA GROUP study demonstrates that those costs are more than compensated by the economic advantages of saving loans from default.

Beyond the quantitative analysis, there is a human dimension to be considered in the debate about forbearances. ... To foreclose on borrowers desperately seeking a way to repay their loans is bad public policy, especially when the broad use of forbearances is cost-effective for taxpayers.

Beyond the quantitative analysis, there is a human dimension to be considered in the debate about forbearances. The fact is, the vast majority of student borrowers eventually repay their loans. The USA GROUP study shows that with the intervention of a conscientious servicer, even the most distressed student borrowers repay their loans in two out of three cases.

The consequences of defaulting on a student loan are devastating to the borrower's credit rating. To foreclose on borrowers desperately seeking a way to repay their loans is bad public policy, especially when the broad use of forbearances is cost-effective for taxpayers.

Conclusion

On the basis of actual experience and case-study analysis, USA GROUP, Inc. supports the view that the U.S. Department of Education should continue its policy of encouraging the broad use of forbearances for student loan borrowers facing financial hardship. The policy is sound on both economic and humanitarian grounds.

USA GROUP, Inc. supports the view that the U.S. Department of Education should continue its policy of encouraging the broad use of forbearances.

Table 1

General Study Statistics

Total number of loans exiting forbearance (1/1/91 - 4/30/92)	24,493
Total number of loans defaulting (as of 10/30/92)	8,363
Total number of loans ***not*** defaulting (as of 10/30/92)	16,130
Average number of forbearance months	9.73
Average loan balance	
·Defaulted loans	$3,739
·Non-defaulted loans	$4,848

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Table 2

Loan Status (Post-Forbearance)

Status	#	%
Current	7,449	30.5
Delinquent (30-179 days past due)	4,042	16.5
Deferred (including forbearance)	2,433	9.9
Paid-in-full	993	4.1
Interim (in-school full-/part-time)	482	2.0
Grace	306	1.3
Delinquent (180 days or more past due)	425	1.7
Defaulted	8,363	34.0
Total	**24,493**	**100.0**

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Table 3

Break-even Analysis

Assumptions

All loans in the sample portfolio were granted a forbearance.
Prior to the forbearance period, no payments were made.

Average loan balance	
·Defaulted loans	$3,739
·Non-defaulted loans	$4,848
Default rate for portfolio	34%
Average months in forbearance	9.73

	# of Loans	$ Balance
Portfolio	24,493	$109,467,497
Loans in default	8,363	$31,269,257
Loans not in default	16,130	$78,198,240

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Table 4

Break-even Analysis Computations

Interest Rate	8.00%	
	Minimum	**Maximum**
Special allowance rate (1/1/91-4/1/92)	0.0000%	0.4298%
Interest paid during forbearance of defaulted loans (9.73 months)	$2,028,332	$2,028,332
Special allowance paid during forbearance on defaulted loans (9.73 months)	$0	$435,889
Total government subsidy on defaulted loans	$2,028,332	$2,464,221
Number of loans which must be saved from default in order to break even	418	508
Loans which must be saved from default as a percentage of non-defaulted loans	2.59%	3.15%

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